

Comments

Protecting an Independent Accountant's Tax Accrual Workpapers from an Internal Revenue Service Summons

I. INTRODUCTION

Tax accrual workpapers,¹ which document an independent accountant's investigation and evaluation of a corporation's potential liability, have become the focus of Internal Revenue Service (IRS or Service) interest.² To gain access to these workpapers the Service has begun to invoke section 7602 of the Internal Revenue Code,³ which authorizes IRS examination of relevant books, papers, records, and other data, to determine a taxpayer's tax liability, to ascertain the correctness of a return, or to collect the tax. The accounting profession's resistance to this relatively recent IRS practice has generated substantial litigation, considerable controversy within the legal and accounting professions, and a vast split among the federal appellate courts.⁴

Two federal circuit courts have decided the issue of IRS access to independent accountants' tax accrual workpapers.⁵ A third has decided the issue only as it pertains to in-house accountants.⁶ Each of the courts, however, has reached a different con-

1. See *infra* text accompanying notes 38-56.

2. See Note, *Government Access to Corporate Documents and Auditors' Workpapers: Shall We Include Auditors Among the Privileged Few?*, 2 J. CORP. L. 349, 349-50 (1977) [hereinafter cited as Note, *Government Access to Corporate Documents*]. The tax accrual workpapers "are of particular interest to the IRS because they contain estimates of a client's exposure to liability for additional income taxes, and, more important, because they pinpoint the precise issues that the client thinks are vulnerable to IRS attack during a tax examination." Caplin, *Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX'N 194, 194 (1979).

3. I.R.C. § 7602 (West Supp. 1982), dealing with the examination of books and witnesses, provides: For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized—

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and,

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

4. *United States v. Arthur Young & Co.*, 677 F.2d 211, 217 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

5. *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983); *United States v. Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977).

6. *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

clusion. In *United States v. Coopers & Lybrand*,⁷ a 1977 case, the Tenth Circuit denied the IRS access to an independent accountant's tax accrual workpapers because the court found that the documents were not "relevant" to determining the correctness of the taxpayer's tax return.⁸ Five years later, in *United States v. Arthur Young & Co.*,⁹ the Second Circuit rejected the lack of relevance argument, but nonetheless shielded the independent accountant's tax accrual workpapers under a work product theory.¹⁰ In *United States v. El Paso Co.*¹¹ the Fifth Circuit rejected both the lack of relevance and the work product theories and ordered the taxpayer's in-house accountants to produce the requested tax accrual workpapers.¹² Thus, three approaches presently exist. To protect tax accrual workpapers, an independent accountant must argue their lack of relevance in the Tenth Circuit, assert the need for a type of work product protection in the Second Circuit, and distinguish the *El Paso* decision in the Fifth Circuit.

After providing background information on audit procedures and an explanation of tax accrual workpapers, this Comment will discuss five justifications for protecting an auditor's tax accrual workpapers. The first approach is the Tenth Circuit's relevance argument, which asserts that tax accrual workpapers deserve protection because they are not "relevant" to determining the correctness of a tax return or the amount of tax liability.¹³ Although this approach recognizes the multiplicity of issues and interests involved when considering IRS access to tax accrual workpapers, it attempts to balance the competing interests on an improper scale. The relevance concept was designed to ensure some logical connection between the tax accrual workpapers and the Service's determination of a tax return's correctness. Because few documents are more likely to throw light upon the correctness of a tax return than are tax accrual workpapers, this approach is rejected as inadequate.¹⁴

The other approaches stem from *United States v. Euge*,¹⁵ in which the Supreme Court noted that the Service's summons authority may be limited by (1) an express statutory prohibition,¹⁶ (2) traditional privileges and limitations,¹⁷ and (3) substantial countervailing policies.¹⁸ No express statutory prohibition exists.¹⁹ Nonetheless, the work product doctrine or the concept of privilege could be applied to protect an accountant's workpapers. Application of either concept to the accountant is imperfect and requires that the theory be stretched beyond presently existing boundaries. This Comment rejects the work product doctrine²⁰ and recommends the judicial creation of

7. 550 F.2d 615 (10th Cir. 1977).

8. See *infra* notes 75-76 and accompanying text.

9. 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

10. See *infra* notes 110-19 and accompanying text and notes 214-19 and accompanying text.

11. 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

12. *Id.* at 545.

13. *United States v. Coopers & Lybrand*, 550 F.2d 615, 621 (10th Cir. 1977).

14. See *infra* text accompanying notes 64-97.

15. 444 U.S. 707 (1980).

16. *Id.* at 711.

17. *Id.* at 714.

18. *Id.* at 711.

19. See *infra* subpart III (B).

20. See *infra* subpart III (C)(1).

a limited accountant-client privilege.²¹ Because many courts disfavor the creation of a novel privilege, however, a final approach, which balances the IRS interests against all substantial countervailing policy considerations, is presented. Balancing all considerations is proper within this approach and plainly supports protecting an accountant's tax accrual workpapers.²²

II. BACKGROUND

The Securities Act of 1933²³ and the Securities Exchange Act of 1934²⁴ require that certified financial statements accompany the registration statement and prospectus of an initial public security offering and all subsequent annual reports filed with the Securities Exchange Commission (SEC).²⁵ An accountant reviews the various components of the financial statement by conducting an audit:²⁶ examining and verifying the financial assessments of corporate management to determine whether they "present fairly the financial information they purport to convey."²⁷ The auditor is guided to the proper scope and depth of the audit by SEC requirements,²⁸ "generally accepted auditing standards,"²⁹ and the possibility of personal liability, both civil and criminal.³⁰

21. See *infra* subpart III (C)(2).

22. See *infra* subpart III (D).

23. 15 U.S.C. §§ 77a-77aa (1976).

24. 15 U.S.C. §§ 78-78ii (1976).

25. See Note, *Government Access to Corporate Documents*, *supra* note 2, at 353 n.13. The author notes that an audit is required whenever a corporation wants to register a new stock issue, Securities Act of 1933 Schedule A (25)-(27), 15 U.S.C. § 77aa (1970); register securities for listing on an exchange, Securities Exchange Act of 1934 §§ 12(b)(1)(J)-(L), 12(g)(1), 15 U.S.C. §§ 78(b)(1)(J)-(L), 78(g)(1) (1970); solicit proxies in order to issue securities, modify a class of securities, or attempt a merger, Schedule 14A, Item 15, 17 C.F.R. § 240.14a-101 (1976); file annual 10-K reports with the Commission, SEC Form 10-K . . . ; or issue the annual report to shareholders in connection with solicitations of proxies, 17 C.F.R. § 240.14a-3(b)(3)-(4) (1976).

Id.

26. Brief for Petitioner-Appellee at 6, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

27. SEC v. Arthur Young & Co., 590 F.2d 787, 788 n.2 (9th Cir. 1979).

28. Regulation S-X, 17 C.F.R. § 210 (1982) is the principle regulation concerning the content and form of the corporation's financial statements. See generally Note, *Government Access to Corporate Documents*, *supra* note 2, at 357.

29. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENTS ON AUDITING STANDARDS NO. 1 § 150 (1972). "The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, result of operations, and changes in financial position in conformity with generally accepted accounting principles." *Id.* § 110.01. These accounting principles are promulgated, in part, by the Financial Accounting Standards Board. See Note, *Government Access to Corporate Documents*, *supra* note 2, at 353 n.13.

One generally accepted accounting principle requires that losses should be accrued by a charge to income if the future event that will fix the loss is "probable" (likely to occur), and the amount of loss can be reasonably estimated. Losses that are "reasonably possible" (more than remote but less than likely) must be disclosed in the financial statements, but need not be accrued. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5: ACCOUNTING FOR CONTINGENCIES ¶¶ 1, 33-39 (1976).

A "contingency" is defined as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain . . . or loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur." *Id.* ¶ 1. See generally J. BOOKER & B. JARNAGIN, FINANCIAL ACCOUNTING STANDARDS: EXPLANATION AND ANALYSIS 354-60 (1980); Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 FORDHAM L. REV. 468, 469-70 (1982).

30. *Nath, Internal Revenue Service Summonses for "Sensitive" Accountants' Papers*, 34 VAND. L. REV. 1561, 1566 (1981).

Before investigating the corporation's financial statements, the auditor, or auditing firm, prepares an audit workplan—a detailed “master plan” that enumerates the “procedures to be followed . . . with a ‘check-off’ method of confirming that such procedures were followed, together with suggestions for future modifications of the plan.”³¹ Because the auditor does not verify every item in the client's records, the auditor must predetermine which, and to what extent, items and records will be examined.³² Thus, the audit workplan has been described as the auditor's “game plan.”³³

The audit workpapers,³⁴ developed and owned by the auditor and upon which the auditor bases his or her opinion, can be classified into two categories.³⁵ The first consists of reports to management, which “evaluate whether the corporation's accounting systems, procedures, and controls are adequate and accurate.”³⁶ The auditor might, for example, investigate and recommend improvements in the system of accounting for bad debts or of taking inventory.³⁷ The second consists of tax accrual workpapers,³⁸ which are prepared by the auditor as he attempts to determine whether the client has set aside sufficient reserves to cover any potential tax liability the client may be required to pay.³⁹ Because “income tax liability is a material factor in computing a corporation's net income,”⁴⁰ an auditor must determine whether the

31. *United States v. Coopers & Lybrand*, 550 F.2d 615, 617 (10th Cir. 1977).

32. Brief for Respondent-Appellant Arthur Young & Co. at 6-7, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), cert. granted, 103 S. Ct. 1180 (1983).

Auditors consider their audit workplan highly confidential because it is individually tailored to effectively examine each client and used each year with specific improvements. If the client were made aware of the audit workplan he could defeat its effectiveness. *United States v. Arthur Young & Co.*, 496 F. Supp. 1152, 1157 (S.D.N.Y. 1980), rev'd, 677 F.2d 211 (2d Cir. 1982), cert. granted, 103 S. Ct. 1180 (1983); see Note, *Government Access to Corporate Documents*, supra note 2, at 356-57. However, an audit work program does not long remain a secret. Because of reuse, the basic aspects of the program are revealed to the client. Furthermore, the movement of accountants between independent accounting firms and corporate accounting departments facilitates access to much information. Note, *Protecting the Auditor's Work Product from the IRS*, 1982 DUKE L.J. 604, 613.

33. Nath, supra note 30, at 1567.

34. The term is defined more narrowly in this Comment than in the Internal Revenue Manual. The latter defines audit workpapers as “workpapers retained by the independent accountant as to the procedures followed, the tests performed, the information obtained, and the conclusions reached . . .” [1 Audit] I.R.M. (CCH) § 4024.2 (rev. May 14, 1981).

35. Audit workpapers might be classified two different ways, but the difference may reflect little more than the desired conclusions. If the division is between (1) the financial data extracted from the taxpayer's records and (2) the auditor's opinion and evaluation, the argument that a privilege should protect the auditor's mental processes is feasible. See generally Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. TAX'N 66, 69-70 (1982). If one divides audit workpapers into (1) the auditor's reports to management, and (2) tax pool analysis, he intimates the indivisibility of fact and opinion within the tax accrual workpapers. See Nath, supra note 30, at 1567, 1572 (categorizing workpapers in this manner).

36. Nath, supra note 30, at 1568.

37. *Id.*

38. Tax accrual workpapers have been referred to as tax pool analysis, tax reserve memoranda, tax reserve papers, tax contingency files, tax provision memoranda, and “documents analyzing potential tax liabilities or tax problems.” *United States v. El Paso Co.*, 682 F.2d 530, 533 (5th Cir. 1982), petition for cert. filed, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716). See generally Caplin, *Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX'N 194, 194 (1979).

39. *United States v. El Paso Co.*, 682 F.2d 530, 534 (5th Cir. 1982), petition for cert. filed, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716); *United States v. Arthur Young & Co.*, 677 F.2d 211, 217 (2d Cir. 1982), cert. granted, 103 S. Ct. 1180 (1983); *United States v. Coopers & Lybrand*, 550 F.2d 615, 617 (10th Cir. 1977).

40. Note, *Government Access to Corporate Documents*, supra note 2, at 357.

“A business must accrue both actual and potential tax liability as a charge against current earnings in order to reflect accurately its financial position. . . . The tax contingency figure is a composite of possible tax consequences, each discounted by the probability that it will occur.” Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers*, 1 VA. TAX REV. 57, 59 (1981) [hereinafter cited as Caplin, *Tax Accrual Workpapers*].

corporation's financial statements accurately reflect the possibility of future government challenges before giving an opinion.⁴¹

When evaluating the adequacy of the client's reserve for contingent tax liability⁴² the accountant must examine the client's books and records and interview corporate management and personnel.⁴³ Candid discussion is vital to the effective performance of the audit function.⁴⁴ To accurately estimate the client's contingent tax liability the accountant must have access to the "opinions, speculations, and projections [of] the client's personnel and legal counsel regarding unclear or aggressive tax positions."⁴⁵ The accountant must be permitted to ask penetrating questions about transactions of a sensitive nature.⁴⁶ This process requires that the accountant serve as a "devil's advocate," raising all issues of potential controversy in the light most favorable to the IRS.⁴⁷ One corporate client noted that accountants explore possible tax consequences on a worst-case basis to

(1) identify issues on the Company's federal tax returns which counsel and other tax compliance personnel think could be subject to challenge in the course of an [IRS] audit because of differences with the IRS on interpretation of law or characterization of fact; (2) speculate on the likelihood that the IRS will raise these issues; (3) evaluate whether the company would litigate the issues raised and estimate its chances of prevailing; (4) review and evaluate the legal implications of the issues identified; (5) estimate the dollar amounts for which the Company would be willing to settle each controversy administratively if it chose not to litigate, and (6) assign a total estimated dollar amount to the aggregate outcome as to all issues discussed.⁴⁸

Tax accrual workpapers are simply the memorialization of this process—a record of the work done and the conclusions reached. The examination and critical analysis therefore necessarily reflect the auditor's opinion, speculation, and judgment.⁴⁹

The documentation might be divided into three categories. First, transactional material is the "collection of raw data relating directly to potential tax issues."⁵⁰ Second, the underlying factual information, such as memoranda of interviews, correspondence with management, and possible settlement positions, represents the fruit of the auditor's search behind the transactional material.⁵¹ The final category is the

41. Nath, *supra* note 30, at 1571.

42. The reserve "is a liability account on the corporation's books representing an estimate of possible future income tax assessments arising from a disallowance of deductions or credits previously taken in computing the corporation's tax liability." Note, *Government Access to Corporate Documents*, *supra* note 2, at 357 n.31.

43. Brief for Respondent-Appellant Arthur Young & Co. at 9, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

44. *Id.*

45. Caplin, *Tax Accrual Workpapers*, *supra* note 40, at 59-60.

46. Nath, *supra* note 30, at 1571.

47. Brief for Respondent-Appellant Arthur Young & Co. at 10, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

48. Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit at 4, *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

49. Brief for Respondent-Appellant Arthur Young & Co. at 10, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

50. Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. TAX'N 66, 70 (1982).

51. *Id.*

auditor's analysis—his cumulative judgment based on the facts and the law as he understands them.⁵² While the client's financial statement identifies the total amount of potential tax liability, it does not break down the figure on an "item-by-item" basis, as do the tax accrual workpapers.⁵³ This, then, is why such workpapers are considered a "definitive road map to the vulnerable areas in a corporate taxpayer's return."⁵⁴

Tax accrual workpapers are not prepared to assist in filling out a tax return or "to respond to a specific charge by the IRS or to any pending or impending lawsuit. [Rather, they are] undertaken solely to ensure that the corporation sets aside on its balance sheet a sufficient amount to cover contingent tax liability."⁵⁵ Frequently the accountant's independence and conservatism will conflict with the client's "desire to maximize the report of earnings."⁵⁶ Thus, the tax accrual workpapers reflect the auditor's determinations, not those of the client.

In summary, tax accrual workpapers (1) are a memorialization (2) of the auditor's investigation and mental processes in determining, (3) for financial reporting purposes, (4) the adequacy of the client's reserve for contingent tax liability, (5) by reviewing the tax laws and (6) the client's books and records, and (7) by discussing the general affairs of the business with management, employees, and the clients of the auditor's client.

III. PROTECTING AN INDEPENDENT ACCOUNTANT'S TAX ACCRUAL WORKPAPERS

A. *Relevance of Tax Accrual Workpapers to an IRS Investigation*

In *United States v. Powell*⁵⁷ the Supreme Court stated the test for judicial enforcement of a section 7602 summons. The Commissioner must show⁵⁸ "that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed"⁵⁹ Once the Commissioner has made the initial showing

52. *Id.*

53. See Caplin, *Tax Accrual Workpapers*, *supra* note 40, at 61.

54. *Id.*

55. *United States v. El Paso Co.*, 682 F.2d 530, 535 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

56. Nath, *supra* note 30, at 1571.

57. 379 U.S. 48 (1964).

58. The government must make a *prima facie* showing, but the burden of proof is considered minimal. It does not require that probable cause be established. *Id.* at 57; see *United States v. El Paso Co.*, 682 F.2d 530, 536 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716); *United States v. Silvestain*, 668 F.2d 1161, 1163 (10th Cir. 1982); *United States v. Kis*, 658 F.2d 526, 536 (7th Cir. 1981), *cert. denied*, 455 U.S. 1018 (1982); *United States v. Garden State Nat'l Bank*, 607 F.2d 61, 71 (3d Cir. 1979); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 330 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021, *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980).

59. *United States v. Powell*, 379 U.S. 48, 57-58 (1964).

The IRS may not use a § 7602 summons in a criminal investigation. *United States v. LaSalle Nat'l Bank*, 437 U.S. 298, 314-16 (1978). Yet rarely are the civil and criminal aspects of an investigation wholly divorced, and the burden is on the summonee to disprove a civil tax determination purpose. *Id.* at 316.

The "in possession" requirement has been literally construed by the courts, thus rejecting the accounting profession's argument that because the Service has all the records of transactions they constructively have "possession" of

the taxpayer is entitled to "challenge the summons on any appropriate ground,"⁶⁰ but the burden is on the taxpayer to establish that enforcement of the summons would be an abuse of the court's process.⁶¹

Although accountants (who are frequently the focus of an IRS summons) might allege the failure to fulfill a number of *Powell* elements, they most frequently attack summonses for demanding documents that are not relevant to the Service's inquiry.⁶² In *United States v. Coopers & Lybrand*⁶³ the accounting firm argued, and the Tenth Circuit agreed, that the documents were not subject to production under an IRS summons because they were not relevant to determining the correctness of a tax return or the amount of tax liability.⁶⁴ In contrast, the Second Circuit in *United States v. Arthur Young & Co.*⁶⁵ concluded that tax accrual workpapers were very relevant and would otherwise be available to the IRS were it not for countervailing policy considerations requiring work product protection for the documents.⁶⁶ In *United States v. El Paso Co.*⁶⁷ the Fifth Circuit wholly agreed with the *Arthur Young* court's understanding of relevance and ordered the taxpayer's in-house accountant to turn over the tax accrual workpapers.⁶⁸ The *El Paso* court, however, did not discuss the issue of an accountant work product protection "because the IRS . . . summoned the tax pool analysis from the taxpayer itself, not from an independent accountant."⁶⁹

The definition of relevance, grappled with in post-*Coopers & Lybrand* litigation, has proved to be an elusive concept.⁷⁰ Limited legislative history on the matter has forced the courts to define the scope of section 7602 without the help of Congress.⁷¹ *United States v. Powell*,⁷² although helpful, has likewise failed to provide adequate guidance. The relevance issue has been further confused by the use of descriptive, yet conclusory language.⁷³

the information in the tax accrual workpapers. *E.g.*, *United States v. Noall*, 587 F.2d 123, 125 n.2 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979). See generally Nath, *supra* note 30, at 1574 n.53; Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 *FORDHAM L. REV.* 468, 473 n.30 (1982).

60. *Reisman v. Caplin*, 375 U.S. 440, 449 (1964).

61. *United States v. Powell*, 379 U.S. 48, 58 (1964).

62. Nath, *supra* note 30, at 1574-75.

63. 550 F.2d 615 (10th Cir. 1977).

64. *Id.* at 621.

65. 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

66. *Id.* at 219.

67. 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

68. *Id.* at 537, 545.

69. *Id.* at 537 n.7.

70. Referring to the relevancy concept, one recent commentator noted that although various courts "tested the same concept against the same standard, their respective resolutions of the question are at opposite poles. This exceedingly malleable standard offers little guidance or predictability." Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 *WASH. U.L.Q.* 185, 203 (1982) [hereinafter cited as Note, *A Balancing Approach*]. The standard of relevance, as presently articulated, may fall anywhere in a broad range. While the IRS need not make a showing of probable cause, it must do more than show that "some chance of relevance exists." *United States v. Harrington*, 388 F.2d 520, 524 (2d Cir. 1968).

71. The final committee report on the present version of § 7602 simply stated, "This section contains no material change from existing law." H.R. REP. NO. 1337, 83d Cong., 2d Sess. A436, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4025, 4584. The then existing law provided a summons authority "to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return." Act of Feb. 24, 1919, ch. 18, § 1305, 40 Stat. 1057, 1142.

72. 379 U.S. 48 (1964).

73. A court attempting to determine the proper test of relevance is not significantly aided by the knowledge that the IRS may have access to a document that "might throw light upon the correctness of the return," *United States v.*

Two approaches for determining relevance have developed: the balancing approach, alluded to by the Tenth Circuit in *Coopers & Lybrand*, and the "throw light upon" approach, first described in *Foster v. United States* by the Second Circuit.⁷⁴ Adherents of the balancing approach argue that "[r]elevancy is inherently a balancing concept such that the courts must weigh the variables in each case on an ad hoc basis."⁷⁵ In *Coopers & Lybrand* the Tenth Circuit enumerated several variables to be considered: (1) whether the taxpayer is merely attempting to frustrate or prevent an IRS inquiry into potential tax liability, (2) whether the summons places an unnecessary burden on the taxpayer, (3) whether the IRS had some indication prior to the audit that the taxpayer was purposely attempting to escape tax liability, (4) whether the summons is "overbroad and disproportionate to the end sought," (5) whether the summons is directed at the taxpayer or a third party (generally an independent auditor), and (6) whether the purpose of the summons is to conduct a "rambling exploration" or "fishing expedition" for the convenience of the IRS.⁷⁶ Recent commentators have both supported a balancing test and proposed other elements that might be considered.⁷⁷ Most courts, however, have been unpersuaded and have rejected the *Coopers & Lybrand* approach.⁷⁸

The "throw light upon" approach, though not well defined, may be outlined as follows. Section 7602 is evidence of a congressional desire to grant the IRS broad authority with which to effectively enforce the revenue laws.⁷⁹ To effectuate this desire, a low-threshold test of relevance, like that used by grand juries, is considered appropriate. The frequently accepted test has been "whether the documents requested 'might have thrown light upon' the correctness of a return."⁸⁰ Courts have noted that

Harrington, 388 F.2d 520, 524 (2d Cir. 1968), but that the IRS may not go on a "fishing expedition" or a "rambling exploration" for the "mere sake of its convenience," *United States v. Coopers & Lybrand*, 550 F.2d 615, 621 (10th Cir. 1977).

74. 265 F.2d 183, 187 (2d Cir.), *cert. denied*, 360 U.S. 912 (1959). It is arguable that only one approach exists and that the various courts differ on which factors they will consider when determining relevance.

75. Note, *A Balancing Approach*, *supra* note 70, at 203 (footnotes omitted).

76. 550 F.2d 615, 621 (10th Cir. 1977).

77. Caplin, *Tax Accrual Workpapers*, *supra* note 40, at 64-68; Note, *A Balancing Approach*, *supra* note 70; Note, *Government Access to Corporate Documents*, *supra* note 2, at 381-82.

78. *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983); *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716); *United States v. Noall*, 587 F.2d 123 (2d Cir. 1978) (taxpayer's internal audit reports and related documents were relevant because they might throw light upon the correctness of the taxpayer's return and were, therefore, summonable by the IRS), *cert. denied*, 441 U.S. 923 (1979); *United States v. Price Waterhouse & Co.*, 515 F. Supp. 997 (N.D. Ill. 1981) (IRS granted access to an independent accountant's tax accrual workpapers because the IRS satisfied the four *Powell* tests, including relevance); *United States v. Riley Co.*, 45 A.F.T.R.2d (P-H) ¶ 80-551 (N.D. Ill. 1980) (independent accounting firm ordered to produce various reports to management because the IRS had satisfied the *Powell* requirements); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass.) (independent accountant's tax accrual workpapers are summonable because they are nonprivileged and highly relevant), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021, *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980); *United States v. First Chicago Corp.*, 43 A.F.T.R.2d (P-H) ¶ 79-426 (N.D. Ill. 1978) (after *in camera* inspection the taxpayer was ordered to produce eight of twenty-three internal audit reports because of their relevance to an IRS audit).

79. *United States v. Arthur Young & Co.*, 677 F.2d 211, 218 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983); *see also United States v. Euge*, 444 U.S. 707, 711 (1980).

80. *United States v. Arthur Young & Co.*, 677 F.2d 211, 218 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983); *United States v. El Paso Co.*, 682 F.2d 530, 537 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

it is "hard to imagine a document more likely to shed light on the correctness of those aspects of a return that harbor doubts than the tax pool analysis."⁸¹

"A thing is RELEVANT when it has a connection, [especially] a logical connection, with a matter under consideration."⁸² The application of the "throw light upon" test to this general definition might be stated as follows: Relevance will be found when the workpapers (the thing) might⁸³ throw light upon (a minimal connection) the correctness of a return (the matter under consideration). Once the required minimal connection is established the relevance requirement is satisfied, regardless of other considerations. Policy concerns, like those enumerated in the *Coopers & Lybrand* decision,⁸⁴ may lead a court to protect an auditor's tax accrual workpapers, but they do not increase or decrease the relevance of tax accrual workpapers to determining the correctness of a return. For example, a taxpayer's desire or attempt to frustrate an IRS investigation does not affect the relevance of the tax accrual workpapers to the determination of tax liability. Likewise, the logical connection between the documents and determining the correctness of the return should not be affected by whether IRS possession of the documents simplifies the Service's procedure.⁸⁵ Tax accrual workpapers may be relevant to determining the correctness of a return and yet make the audit either more difficult or simpler to perform. Seeking tax accrual workpapers because they make an IRS audit more convenient does not make the workpapers less relevant.⁸⁶

Because relevance inherently refers to a relationship or connection between facts, a given document's relevance ultimately turns upon the facts of the particular case. Thus, a document may be relevant in one context, but irrelevant in another.⁸⁷

81. *United States v. El Paso Co.*, 682 F.2d 530, 537 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

82. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1917 (1970) (emphasis in original). "[One] [f]act is relevant to another fact when, according to [the] common course of events, existence of one taken alone or in connection with the other fact renders existence of the other certain or more probable." BLACK'S LAW DICTIONARY 1160 (5th ed. 1979).

83. "Might" requires "in the particular circumstance an indication of a realistic expectation rather than an idle hope that something may be discovered." *United States v. Harrington*, 388 F.2d 520, 524 (2d Cir. 1968).

84. See *supra* text accompanying note 76.

85. Nath, *supra* note 30, at 1586.

86. One commentator recently suggested that courts are applying a standard of relevancy different from the "throw light upon" standard. Supposedly, "convenience is being viewed as sufficient to establish relevance." Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 FORDHAM L. REV. 468, 477-78 (1982). The Second and Fifth Circuits did not rely on the convenience factor to establish relevance. Rather, they recognized that convenience does not indicate irrelevance. *United States v. El Paso*, 682 F.2d 530, 537-38 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716); *United States v. Arthur Young & Co.*, 677 F.2d 211, 219 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

Another writer admitted that "the auditor's workpapers do shed some light on the taxpayer's tax positions," but argued that because the workpapers reflect upon the taxpayer's tax position "only indirectly" they should be considered "little more than a convenience to the IRS." Note, *Protecting the Auditor's Work Product from the IRS*, 1982 DUKE L.J. 604, 618. The author correctly recognized, first, that a logical connection exists between the workpapers and determining the correctness of a return so that the papers may pass the legal test of relevance and second, that convenience may be the Service's dominant purpose for summoning tax accrual workpapers. The recommended solution is a change in the *Powell* relevance test. *Id.* at 620. Because this author's attack focuses on the Service's purpose for summoning the workpapers, however, the argument for change applies most clearly to the first prong of the *Powell* test. See *supra* text accompanying note 59.

87. Caplin, *Tax Accrual Workpapers*, *supra* note 40, at 65.

Relevance may also exist in varying degrees based on the circumstances of a particular case,⁸⁸ but the elements outlined by the *Coopers & Lybrand* court do not indicate relevance.

Perhaps a more effective argument would be that these considerations in some way affect one of the other prongs of the *Powell* test.⁸⁹ The first prong of the test requires the IRS to "show that the investigation will be conducted pursuant to a legitimate purpose"⁹⁰ While determining tax liability or the correctness of a taxpayer's return is clearly a legitimate purpose, every means of performing an inquiry is not thereby authorized or condoned. Determining whether a purpose is "legitimate" may more properly involve the balancing test employed by the Tenth Circuit.⁹¹ IRS summonses seeking the legal opinions and theories of an outside agent when the IRS has all the raw data, simply for the sake of convenience, may be considered illegitimate by a court.

Judge Garwood, in his *El Paso* dissent, attacked the majority's "throw light upon" approach.⁹² He argued that when Congress enacted section 7602 to require that books, papers, records, and other data be relevant to "such inquiry," the legislature meant that the various items must be relevant to "the correctness of any return" or "liability of any person" not simply relevant to "ascertaining" or "determining" correctness or liability.⁹³ The workpapers must be relevant to the subject matter of the inquiry rather than merely to the inquiry itself.

This attempt to find a prohibition on the use of information relevant to determining the correctness of a return in the wording of section 7602 is unpersuasive. First, "inquiry" connotes investigation, search, probe, or quest, all of which involve process. Nothing in section 7602 indicates a different interpretation.⁹⁴ Second, since section 7602 permits the IRS access to documents and data for use in "making a return where none has been made" it is illogical to preclude documents relevant to ascertaining the tax liability of a person.⁹⁵ If the Service were granted access only to documents used in the preparation of an existing tax return, it could never fulfill the function of making out a return when none has been previously made, because no documents would exist.

In his second, and potentially more important argument, Judge Garwood indicated that the "throw light upon" test should mean and actually has meant "throw *factual* light upon."⁹⁶ Garwood felt that the Second Circuit's attempt to protect outside accountants' tax accrual workpapers could be better accomplished by narrowly construing section 7602 and restricting relevance to factual information.⁹⁷

88. *Id.* at 64.

89. See *supra* text accompanying note 59.

90. *United States v. Powell*, 379 U.S. 48, 57 (1964).

91. See *supra* text accompanying note 76.

92. 682 F.2d 530, 547-49 (5th Cir. 1982) (Garwood, J., dissenting).

93. *Id.* at 546-47.

94. See *supra* note 3.

95. *Nath*, *supra* note 30, at 1578.

96. 682 F.2d 530, 546, 547-49 (5th Cir. 1982) (Garwood, J., dissenting) (emphasis added).

97. Narrow construction of § 7602 might be supported as follows: I.R.C. § 7605(b), while limited by the *Powell* decision, states that "[n]o taxpayer shall be subjected to unnecessary examination or investigations" I.R.C. §

This proposal likewise suffers from a number of problems. Distinguishing factual information from personal viewpoints and interpretations is frequently impossible. Factual information can be sheltered amidst impressions, opinions, and theories. In addition, some mental impressions, opinions, and theories might be protected under this approach even though countervailing considerations warranting protection are lacking.

B. Express Statutory Prohibitions

In *United States v. Euge* the Supreme Court noted that the Service's congressionally mandated summons authority "should be upheld absent express statutory prohibition"⁹⁸ Yet no express language in section 7602⁹⁹ or in the securities laws prohibits the IRS from summoning an accountant's tax accrual workpapers.¹⁰⁰ If an express statutory limitation on the Service's summons authority were the only means of protecting an accountant's workpapers, congressional action would be required.¹⁰¹ The Supreme Court, however, has established other standards for protecting an accountant's tax accrual workpapers.

C. Traditional Privileges and Limitations

In *Couch v. United States*¹⁰² the Supreme Court announced that "no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases."¹⁰³ Accountants litigating IRS access to tax accrual workpapers, and the accounting profession generally, thereafter abandoned the privilege argument¹⁰⁴ and instead asserted that substantial policy factors

7605(b) (1982). Mental impressions, legal analyses, conclusions, and recommendations are no more than personal viewpoints. If permitted access to all factual records and data, the IRS can perform all the investigations and calculations necessary for determining one's tax liability or the correctness of a taxpayer's return. Restricting relevance to factual information minimizes the already intrusive and abusive nature of our tax collecting system.

98. *United States v. Euge*, 444 U.S. 707, 711 (1980). Throughout the opinion the Court notes at least four standards with gradually decreasing need for congressional mandate and increasing importance of policy considerations. The standards are as follows: (1) "express statutory prohibition," (2) "contrary legislative purposes," (3) "countervailing policies enunciated by Congress," and (4) "substantial countervailing policies." *Id.* at 711, 716.

99. See *supra* note 3.

100. *United States v. Arthur Young & Co.*, 677 F.2d 211, 221-22 (2d Cir. 1982) (Newman, J., concurring in part and dissenting in part), *cert. granted*, 103 S. Ct. 1180 (1983). The *Arthur Young* dissenter noted that the majority did not find "anything in the text or legislative history of § 7602 to support an exception of an accountant's tax accrual workpapers." *Id.*

101. A recent Note argued that § 7602 should be amended to protect accountants' tax accrual workpapers by limiting access to some third party documents. Note, *Protecting the Auditor's Work Product from the IRS*, 1982 DUKE L.J. 604, 626. Supposedly judicial change is too slow to remedy any dispute. *Id.* Yet, as the dissenter in *Arthur Young* noted, Congress has been aware of the controversy since at least 1979, when *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass.), *appeal dismissed*, 612 F.2d 569 (1st Cir. 1979), *appeal of one party dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021, *aff'd as to second party*, 623 F.2d 725 (1st Cir. 1980), was decided, but has failed to take action. *United States v. Arthur Young & Co.*, 677 F.2d 211, 222 (2d Cir. 1982) (Newman, J., concurring in part and dissenting in part), *cert. granted*, 103 S. Ct. 1180 (1983). See also Note, *Government Access to Corporate Documents*, *supra* note 2, at 388, suggesting a statutorily created auditor-client testimonial privilege along the lines of the newspaper-source privilege proposed in *Branzburg v. Hayes*, 408 U.S. 665, 743 (1972) (Stewart, J., dissenting).

102. 409 U.S. 322 (1973).

103. *Id.* at 335.

104. One critic has argued that "the accountants' objective clearly is the recognition of what amounts to an accountant-client privilege by some other name . . . [and] that their goal is a variation on the work product doctrine that is less than a privilege, but which only a showing of substantial need—such as the likely presence of fraud—can overcome." Nath, *supra* note 30, at 1599 n.159.

require that the tax accrual workpapers not be produced.¹⁰⁵ Yet, as noted above, the Supreme Court recently enumerated three restrictions that may limit the scope of a section 7602 summons¹⁰⁶ and included "traditional privileges and limitations"¹⁰⁷ as the second of these. In *Upjohn Co. v. United States*¹⁰⁸ the Court identified the work product doctrine and the attorney-client privilege as the types of traditional limitations that would restrict the Service's summons authority.¹⁰⁹

Citing to these Supreme Court decisions, the Second Circuit fashioned a type of work product protection for an independent accountant's tax accrual workpapers. In *United States v. Arthur Young & Co.*¹¹⁰ the Second Circuit rejected the accountant's lack of relevance argument, yet refused to compel production of the documents. As the court stated, "the countervailing policies at issue . . . require us to fashion protection for the work that independent auditors, retained by publicly owned companies to comply with the federal securities laws, put into preparation of tax accrual workpapers."¹¹¹ Chief Judge Feinberg created the work product protection, citing *United States v. Euge*,¹¹² in which the Supreme Court noted that "contrary legislative purposes" can undercut the "broad latitude" granted to the IRS,¹¹³ and *Upjohn Co. v. United States*,¹¹⁴ which recognized that common-law privileges serve to limit the scope of the IRS' summons power.¹¹⁵ The Second Circuit fashioned its protection around the work product doctrine enunciated by the Supreme Court in *Hickman v. Taylor*.¹¹⁶ The *Arthur Young* court indicated that whenever "strong public policies" outweigh a "party's need for information," *Hickman* requires a court to apply a balancing approach.¹¹⁷ The court accepted the accounting firm's argument that complete disclosure by the client is necessary for "the maintenance of fair and honest markets in [securities] transactions."¹¹⁸ Shielding the "written statement, private memoranda and personal recollections" memorialized in an accountant's tax accrual workpapers is necessary to assure complete candor in the accountant-client relationship.¹¹⁹ Thus, the tax accrual workpapers, which would save the IRS time

105. Brief for Respondent-Appellant Arthur Young & Co. at 33, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983). The taxpayer in *El Paso* argued that the summons should not be enforced "[a]s a matter of public policy." Brief of Appellant at 48, *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

106. *United States v. Euge*, 444 U.S. 707 (1980); *see supra* text accompanying notes 15-18.

107. *United States v. Euge*, 444 U.S. 707, 714 (1980).

108. 449 U.S. 383 (1981).

109. *Id.* at 397-98, 389-97.

110. 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

111. *Id.* at 219. This statement defines the privilege created by the court and delineates its requirements. A careful reading of the decision will indicate that the holding is extremely narrow. The court explained that it was compelled to create a privilege only because of "the countervailing policies at issue in the case before us." *Id.* (emphasis added).

112. 444 U.S. 707 (1980).

113. *Id.* at 716 & n.9.

114. 449 U.S. 383 (1981).

115. *Id.* at 397-98.

116. 329 U.S. 495 (1947).

117. *United States v. Arthur Young & Co.*, 677 F.2d 211, 219 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

118. *Id.*

119. *Id.* at 219-20.

and effort by serving as a road map through the taxpayer's return, are not important enough to justify jeopardizing the reliability of the data on which the investing public relies.

The *Arthur Young* reasoning was rejected in *United States v. El Paso Co.*¹²⁰ The Fifth Circuit ordered the taxpayer's in-house accountants to produce their tax accrual workpapers in compliance with an IRS summons.¹²¹ While the court did not reach the issue of an accountant work product protection,¹²² it did note that "[t]o extend *Arthur Young* to this case would, in effect, create an accountant-client communications privilege," which the court was unwilling to do absent legal precedent.¹²³ The court further rejected the *Arthur Young* court's analysis by denying a work product protection to the tax pool analysis prepared by the taxpayer's attorneys¹²⁴ and by rejecting the *Arthur Young* court's policy arguments.¹²⁵

1. Work Product Protection

In *Hickman v. Taylor*¹²⁶ the Supreme Court "recognized a qualified privilege for certain materials prepared by an attorney 'acting for his client in anticipation of litigation.'"¹²⁷ The work product doctrine,¹²⁸ embodied in Rule 26 of the Federal Rules of Civil Procedure,¹²⁹ provides a qualified immunity for (1) "documents and tangible things; (2) prepared in anticipation of litigation or for trial; and (3) by or for another party or by or for that other party's representative."¹³⁰ The strong public policies underlying the doctrine, recently reaffirmed by the Supreme Court,¹³¹ are largely intangible, subtle, and vaguely defined.¹³² A number of arguments have been given to support the assertion that without the doctrine "[i]nefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial."¹³³ Without work product protection, "much of what is now put down in writing would remain unwritten."¹³⁴ The diligent and competent lawyer might be discouraged "from exerting his fullest efforts to develop his client's case."¹³⁵ Unlimited discovery might promote a wait-and-see attitude, if not laziness

120. 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

121. *Id.* at 545.

122. *Id.* at 537 n.7.

123. *Id.* at 541.

124. *Id.* at 542-44.

125. *Id.* at 544-45.

126. 329 U.S. 495 (1947).

127. *United States v. Nobles*, 422 U.S. 225, 237-38 (1974) (citing *Hickman v. Taylor*, 329 U.S. 495, 508 (1947)).

128. *Upjohn Co. v. United States*, 449 U.S. 383, 397 (1981). The doctrine has been referred to as a "privilege" or an "immunity" by courts and commentators alike. This type of reference is confusing, if not misleading. It is more precisely a protection, or a qualified immunity that may be overcome with an appropriate showing of need. Note, *Discovery: Hickman v. Taylor, A Decade Later*, 37 N.D.L. REV. 67, 68 (1961).

129. FED. R. CIV. P. 26(b)(3).

130. 8 C. WRIGHT & A. MILLER, *FEDERAL PRACTICE AND PROCEDURE* § 2024, at 196-97 (1970).

131. *Upjohn Co. v. United States*, 449 U.S. 383, 398 (1981).

132. See Case Comment, *The Derivative Use of Attorneys' Opinion Work Product in IRS Summons Enforcement Proceedings: United States v. Bonnell*, 65 MINN. L. REV. 488, 492 n.21 (1981).

133. *Hickman v. Taylor*, 329 U.S. 495, 511 (1947).

134. *Id.*

135. *Developments in the Law—Discovery*, 74 HARV. L. REV. 940, 1029 (1961).

on the part of opposing counsel.¹³⁶ Furthermore, clients might be "reluctant to disclose all facts, favorable and unfavorable to their counsel."¹³⁷ Other commentators have argued that the protection is necessary to maintain the adversarial system, that the lawyer has a proprietary interest in his work product—the fruit of his own labors, and that the doctrine is needed to avoid the freezing of issues prior to trial.¹³⁸ Although each of these justifications and the doctrine itself have been attacked by critics,¹³⁹ the doctrine serves an important function if it encourages complete preparation for trial and zealous representation of clients. The Supreme Court recently concluded that the doctrine and the strong underlying policies were sufficient to allow an attorney's memoranda and a recording of a witness interview to be protected from an IRS summons.¹⁴⁰

In its petition for a writ of certiorari, the IRS argued that the *Arthur Young* court "erroneously extended the work-product doctrine beyond its settled and appropriate bounds."¹⁴¹ In *Hickman* the Supreme Court was concerned with attorneys and material prepared in anticipation of litigation—not with accountants' tax accrual workpapers prepared in the course of a regular audit.¹⁴² Furthermore, so the argument goes, the purpose of work product protection is not primarily to foster candid communications between parties in a relationship: that, the Service claims, is "the essence of a communications privilege."¹⁴³ Thus, one must decide, first, whether an independent accountant's tax accrual workpapers are the type of documents that should be protected; second, whether the documents meet the "prepared in anticipation of litigation" requirement; and third, whether the work product doctrine could possibly achieve the accounting profession's objective.

The analogy between the material produced by an attorney and the tax accountant's tax accrual workpapers is strong.¹⁴⁴ Both are prepared by the professional after assessing the strengths and weaknesses of a client's position, and both contain the

136. *Id.*

137. Case Comment, *The Derivative Use of Attorneys' Opinion Work Product in IRS Summons Enforcement Proceedings*: United States v. Bonnell, 65 MINN. L. REV. 488, 492 (1981).

138. Comment, *The Potential for Discovery of Opinion Work Product Under Rule 26(b)(3)*, 64 IOWA L. REV. 103, 115–16 (1978).

139. For a discussion of the doctrine and the various underlying rationales, see generally Gardner, *Agency Problems in the Law of Attorney-Client Privilege: Privilege and "Work Product" Under Open Discovery* (pt. 2), 42 U. DET. L.J. 253, 268–82 (1965); Note, *Discovery of an Attorney's Work Product in Subsequent Litigation*, 1974 DUKE L.J. 799, 808–09; *Developments in the Law—Discovery*, 74 HARV. L. REV. 940, 1028–30 (1961); Note, *Work Product Discovery: A Multifactor Approach to the Anticipation of Litigation Requirement in Federal Rule of Civil Procedure 26(b)(3)*, 66 IOWA L. REV. 1277, 1280–86 (1981) [hereinafter cited as Note, *Work Product Discovery*]; Comment, *The Potential for Discovery of Opinion Work Product Under Rule 26(b)(3)*, 64 IOWA L. REV. 103, 114–16 (1978).

140. *Upjohn Co. v. United States*, 449 U.S. 383, 400, 402 (1981).

141. Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 10, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), cert. granted, 103 S. Ct. 1180 (1983).

142. *Id.*

143. *Id.* at 10–11.

144. *Arthur Young & Co.* sought protection for their audit program and tax accrual workpapers. The subsequent textual discussion refers to the tax accrual workpapers alone. The district court found that the audit program was not relevant to determining the correctness of any return and the Service did not appeal this finding. *United States v. Arthur Young & Co.*, 677 F.2d 211, 215 (2d Cir. 1982), cert. granted, 103 S. Ct. 1180 (1983).

theories and strategies needed to support the client in subsequent litigation.¹⁴⁵ The words of the *Hickman* Court are applicable in both cases:

Proper preparation of a client's case demands that he assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy. . . . This work is reflected . . . in interviews, statements, memoranda, correspondence, briefs, mental impressions, personal beliefs, and countless other tangible and intangible ways¹⁴⁶

No sure test has been formulated for determining whether documents were prepared in anticipation of litigation.¹⁴⁷ Courts and commentators have offered such a variety of formulas for guidance that the result has been general confusion.¹⁴⁸ Perhaps the best approach would be to consider a number of factors¹⁴⁹ to determine "whether, in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation."¹⁵⁰

The accountants' arguments must focus on the purpose of the "in anticipation of litigation" requirement. The work product doctrine is intended to promote complete trial preparation and competent representation.¹⁵¹ If an attorney does not anticipate or fear discovery of information he has collected for litigation, the manner in which he prepares for litigation should remain unaffected.¹⁵² On the other hand, if an attorney, or an accountant, can anticipate that the material he creates will be revealed to the opposing party prior to litigation, the manner in which he prepares for trial may be substantially affected. When preparing tax accrual workpapers an accountant must anticipate litigation, the legal theories that will be relied upon, the probable outcome, and the settlement figures that would be in the taxpayer's favor.¹⁵³ If the Service were to gain access to this information it would bring two results. First, it would flag the soft spots on the taxpayer's return,¹⁵⁴ inviting IRS-initiated litigation. Second, it would inform the Service of the legal theories and the strategies to be used at trial. Certainly, the effect on the accounting profession would be demoralizing "[a]nd the interests of the clients and the cause of justice would be poorly served."¹⁵⁵

145. Brief for Respondent-Appellant Arthur Young & Co. at 30, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), cert. granted, 103 S. Ct. 1180 (1983).

146. *Hickman v. Taylor*, 329 U.S. 495, 511 (1947).

147. "For example, some courts indicate that a party or its representative anticipates litigation when there is a 'substantial probability' of 'imminent' litigation or when there is a 'prospect' of litigation. Another requirement is that there be 'some possibility' of litigation; however, a 'mere possibility' of litigation is not enough." Note, *Work Product Discovery*, *supra* note 139, at 1277-78.

148. See, e.g., *In re Grand Jury Investigation*, 599 F.2d 1224, 1229 (3d Cir. 1979); *Kent Corp. v. NLRB*, 530 F.2d 612, 623 (5th Cir. 1976).

149. Note, *Work Product Discovery*, *supra* note 139, at 1299.

150. 8 C. WRIGHT & A. MILLER, *FEDERAL PRACTICE AND PROCEDURE* § 2024, at 198 (1970).

151. Note, *Work Product Discovery*, *supra* note 139, at 1288-99.

152. *Id.* at 1289-90.

153. See *supra* notes 38-49 and accompanying text.

154. Caplin, *Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX'N 194, 194 (1979).

155. *Hickman v. Taylor*, 329 U.S. 495, 511 (1947).

The Service could argue that tax accrual workpapers are routinely prepared as required by the accounting profession and the SEC, with no temporal connection between the audit and any potential litigation and with no specific event, other than the annual auditing process, spawning their creation.¹⁵⁶ Thus, the only factor favoring a conclusion that the documents were prepared in anticipation of litigation is that they contain legal analyses, theories, and mental impressions.¹⁵⁷ If that were not true, no work product issue would be present.

In a number of respects the work product doctrine, a theory laden with judicial requirements for its application,¹⁵⁸ is a helpful and workable framework within which to protect an independent accountant's tax accrual workpapers. First, an accountant's work product can be broken down into three categories of documents,¹⁵⁹ with each requiring a different showing of need by the Service. Facts would not be protected. Documents generally prepared by the accountant would be protected, but upon an IRS showing of "substantial need" and an inability "without undue hardship to obtain the substantial equivalent of the materials by other means,"¹⁶⁰ the Service could gain access to the documents. The last category, an accountant's opinion work product, would remain "virtually sacrosanct."¹⁶¹ Under this type of classification most relevant information would be available to the IRS. The Service would not be denied the information necessary to determine the correctness of a return or the amount of a person's tax liability.¹⁶² The work product doctrine therefore represents a middle position between full disclosure and complete immunity.¹⁶³ It allows the Service to perform the tax collecting function with increased efficiency, but does not invade the sanctity of a professional's opinion as expressed in his work product. Furthermore, application of the doctrine may be considered on a case-by-case basis, thereby allowing the circumstances of each case to be individually considered. While this may create additional litigation, it may be more just and may provide taxpayers with a more favorable view of our taxing and judicial systems.¹⁶⁴

Second, the work product protection is not waived by disclosure to a third party unless the disclosure "substantially increase[s] the opportunities for potential adversaries to obtain the information."¹⁶⁵ Unlike an accountant-client privilege,

156. See generally *Developments in the Law—Discovery*, 74 HARV. L. REV. 940, 1030 (1961).

157. See *supra* note 52 and accompanying text.

158. *Developments in the Law—Discovery*, 74 HARV. L. REV. 940, 1030-39 (1961).

159. See *supra* notes 50-52 and accompanying text.

160. FED. R. CIV. P. 26(b)(3).

161. Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. TAX'N 66, 70 (1982).

162. For example, when a corporation's internal records are destroyed by fire and the memoranda being sought cannot be construed as "nonfactual," the government would satisfy the showing of need to overcome the work product protection. See Caplin, *Should The Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX'N 194, 199 (1979).

163. 8 C. WRIGHT & A. MILLER, *FEDERAL PRACTICE AND PROCEDURE* § 2022, at 188 (1970).

164. In its Petition for a Writ of Certiorari, the taxpayer in *El Paso* stated that "before any such access is permitted, we believe that this Court should assess its fairness and its likely effect on our voluntary self-assessment tax system." Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit at 21, *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

165. 8 C. WRIGHT & A. MILLER, *FEDERAL PRACTICE AND PROCEDURE* § 2024, at 210 (1970).

work product protection would thus allow an accountant to comply with his professional responsibilities and the requirements of the securities laws without waiving the privilege as to potential adversaries.

Last, the requirement that an attorney be exercising legal skill to receive the protection¹⁶⁶ could be applied beneficially to the accountant serving as auditor. The accountant would receive no work product protection when involved in "routine business activities."¹⁶⁷ Work product would be protected, however, if it included "interviews, statements, memoranda, correspondence, briefs, mental impressions, personal beliefs, and countless other tangible and intangible"¹⁶⁸ items collected and prepared with an eye towards determining whether the tax accrual reserve will cover potential losses from anticipated litigation.

Although the work product doctrine in many respects provides a helpful framework for analysis, it suffers from the problems previously noted. The "in anticipation of litigation" requirement is not easily stretched to fit the tax accrual workpaper situation.¹⁶⁹ Although access to the workpapers would assuredly instigate litigation, and even though the workpapers are an attempt by accountants to anticipate litigation in which their clients may become involved, the workpapers are not prepared "in connection with litigation, no matter how remotely contemplated."¹⁷⁰ The *Arthur Young* court correctly recognized that requiring the accountant to expose "to the Service appraisals of a taxpayer's weaknesses and settlement positions on audit"¹⁷¹ is prejudicial and substantially unfair to the taxpayer. The work product doctrine, however, may not be the proper means of remedying the injustice.¹⁷²

The work product doctrine was not created to satisfy the objectives that the *Arthur Young* court sought to achieve. Denial of the protection would do very little to discourage complete trial preparation or decrease the quality of legal representation at trial. Furthermore, the desire to foster "candid communications between client and accountant for the benefit of the investing public and the enforcement of the securities laws . . . is the essence of a communications privilege."¹⁷³ The *Arthur Young* court correctly decided the issue, but arguably for the wrong reason. The majority recognized the many policy considerations involved and sought to structure a remedy by intertwining the work product doctrine and the accountant-client privilege. Given the Supreme Court's recognition that "substantial countervailing policies" may limit the Service's summons power, it was unnecessary to stretch the work product doctrine beyond its established form.

166. *Developments in the Law—Discovery*, 74 HARV. L. REV. 940, 1032 (1961).

167. *Id.* at 1033.

168. *Hickman v. Taylor*, 329 U.S. 495, 511 (1947).

169. *See supra* note 147.

170. Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 10, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

171. *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

172. *See infra* subparts III (C)(2) and III (D).

173. Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 11, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

2. Accountant-Client Privilege

The most significant interest the *Arthur Young* court sought to protect was the free and open exchange of ideas between the outside auditor and the client.¹⁷⁴ Yet this is the underlying rationale for a confidential communications privilege rather than for a form of work product protection.¹⁷⁵ The two concepts, though frequently confused, are clearly distinct.¹⁷⁶ The Supreme Court has noted that the attorney-client privilege does not extend to or "concern the memoranda, briefs, communications and other writings prepared by counsel for personal use in prosecuting a client's case; and it is equally unrelated to writings which reflect an attorney's mental impressions, conclusions, opinions or legal theories."¹⁷⁷

A privilege is an exemption from the oft-repeated rule that the public has a right to every man's evidence.¹⁷⁸ Thus, while "the primary assumption [is] that there is a general duty to give what testimony one is capable of giving,"¹⁷⁹ Wigmore has explained that an exception is made when four fundamental conditions exist:

- (1) The communications must originate in a *confidence* that they will not be disclosed.
- (2) This element of *confidentiality must be essential* to the full and satisfactory maintenance of the relation between the parties.
- (3) The *relation* must be one which in the opinion of the community ought to be sedulously *fostered*.
- (4) The *injury* that would inure to the relationship by the disclosure of the communications must be *greater than the benefit* thereby gained for the correct disposal of litigation.¹⁸⁰

The purpose of a privilege is the protection of interests and relationships considered important enough to warrant an incidental encroachment on the efficient administration of justice.¹⁸¹ To ensure complete freedom of communication between an advisor and his client, "the apprehension of compelled disclosure by the . . . advisor

174. *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

175. *Id.* at 223 n.5.

176. *United States v. Nobles*, 422 U.S. 225, 238 n.11 (1974); *see supra* note 128. Although the work product doctrine traditionally has been considered an immunity from discovery, some commentators have understood recent Supreme Court decisions as going "some way toward turning the immunity into a privilege. As such, the 'work product' doctrine is within Rule 501." 23 C. WRIGHT & K. GRAHAM, *FEDERAL PRACTICE AND PROCEDURE* § 5423, at 699-700 (1980). Despite this assertion, the Wigmore test for privilege, *see infra* note 180 and accompanying text, is inappropriate to the work product doctrine because the protection of a relationship is not the primary purpose of the doctrine.

177. *Hickman v. Taylor*, 329 U.S. 495, 508 (1947).

178. 8 J. WIGMORE, *EVIDENCE* § 2291, at 554 (J. McNaughton rev. ed. 1961); *see United States v. Nixon*, 418 U.S. 683, 709 (1974).

179. 8 J. WIGMORE, *supra* note 178, § 2192, at 70.

180. *Id.* § 2285, at 577 (emphasis in original). Wigmore notes that the absence of any one of these conditions justifies rejection of the privilege. *Id.*

181. McCormick, *The Scope of Privilege in the Law of Evidence*, 16 TEX. L. REV. 447, 447-48 (1938); Katsoris, *Confidential Communications—The Accountants' Dilemma*, 35 FORDHAM L. REV. 51, 53 (1966) (quoting McCormick, *supra*).

must be removed."¹⁸² Nevertheless, application of the privilege doctrine to accountants has been attacked on a number of grounds.

The first argument against creating an accountant-client privilege, and the one invariably relied upon by the federal courts, focuses on *Couch v. United States*,¹⁸³ in which the Supreme Court explicitly refused to recognize an accountant-client privilege. While the Court clearly stated in dicta that "no confidential accountant-client privilege exists under federal law,"¹⁸⁴ this does not conclude a critical inquiry; an investigation of what the law should be is not completed simply by determining what the present law is.¹⁸⁵ Since the *Couch* decision in 1973 the Supreme Court has heard a number of cases dealing with the law of privilege¹⁸⁶ from which one might conclude that this area of the law is still evolving.¹⁸⁷ In *Trammel v. United States*¹⁸⁸ the Supreme Court indicated that "[t]he Federal Rules of Evidence acknowledge the authority of the federal courts to continue the evolutionary development of testimonial privileges . . . 'governed by the principles of the common law as they may be interpreted . . . in the light of reason and experience.'"¹⁸⁹ The Court continued by asserting, "Congress manifested an affirmative intention not to freeze the law of privilege."¹⁹⁰

A second argument against the recognition of an accountant-client privilege is its failure to satisfy the requirements of Wigmore's four-part privilege test.¹⁹¹ The first two requirements are not satisfied, so the argument goes, because confidentiality between the accountant and the client is neither expected by the parties nor essential to the full and satisfactory maintenance of the relationship.¹⁹² The Supreme Court

182. 8 J. WIGMORE, *supra* note 178, § 2291, at 545. One commentator asserted that the *Arthur Young* court created a so-called work product privilege "to ensure the vindication of an important public policy, the integrity of the marketplace," rather than to protect "the relationship between accountant and client." Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 FORDHAM L. REV. 468, 487 (1982). It is the impairment of the accountant-client relationship, however, that threatens the measure of reliance a securities investor may place on an accountant's opinion to the certified financials.

183. 409 U.S. 322 (1973). Courts frequently cite to *Couch* to reject any accountant-client privilege without further consideration. See, e.g., *In re International Horizons, Inc.*, 689 F.2d 996, 1004 (11th Cir. 1982); *United States v. El Paso Co.*, 682 F.2d 530, 540 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

184. 409 U.S. 322, 335 (1973).

185. "When precedent and precedent alone is all the argument that can be made to support a court-fashioned rule, it is time for the rule's creator to destroy it." *Francis v. Southern Pacific Co.*, 333 U.S. 445, 471 (1948) (dissenting opinion).

186. See, e.g., *Upjohn Co. v. United States*, 449 U.S. 383 (1981); *Trammel v. United States*, 445 U.S. 40 (1980).

187. Brief for Respondent-Appellant *Arthur Young & Co.* at 39-40 n.36, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

188. 445 U.S. 40 (1980).

189. *Id.* at 47 (quoting FED. R. EVID. 501).

190. *Id.* Rule 501 of the Federal Rules of Evidence can be viewed as a two-part test. The first component is static and requires a court to determine how an issue would have been resolved at common law. The second component—interpretation in light of reason and experience—is a dynamic concept, permitting change in the law of privilege. 23 C. WRIGHT & K. GRAHAM, *FEDERAL PRACTICE AND PROCEDURE* § 5425, at 704-05 (1980).

191. See *supra* note 180 and accompanying text.

192. *Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 12-13, United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

Louisell attacks Wigmore's four-part test as it applies to attorneys and asserts that the privilege is valuable, not to ensure that the attorney gets all essential information, but to avoid the unhealthy moral state that compelled disclosure of a client's confidence creates in the practitioners. Louisell, *Confidentiality, Conformity and Confusion: Privileges in Federal*

recognized that "there can be little expectation of privacy where records are handed to an accountant, knowing that mandatory disclosure of much of the information therein is required in an income tax return."¹⁹³ Accountants occasionally must reveal their workpapers to demonstrate that they have properly discharged their duty.¹⁹⁴ The relationship between accountant and client is not damaged by the lack of privilege, because the client has "an independent legal duty to make the disclosures . . . without reference to or encouragement by any privilege."¹⁹⁵

The response to this argument is threefold. First, the information contained in tax accrual workpapers is not required in an income tax return, nor is the information compiled to assist in preparing the tax return.¹⁹⁶ Second, the accounting profession's Code of Professional Ethics requires that "[a] member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client."¹⁹⁷ Even the IRS recognizes that the opinions and theories found in tax accrual workpapers are conveyed to the independent accountant in confidence.¹⁹⁸ Third, the argument that the IRS should be permitted access to the tax accrual workpapers because the client and accountant should have expected IRS access would support granting the privilege in at least the Second and Tenth Circuits, where a realistic expectation of confidentiality may exist since the IRS has been denied access to the accountants' tax accrual workpapers in the *Arthur Young* and *Coopers & Lybrand* cases. Moreover, this argument that no privilege should be granted because the confidentiality requirement is violated by the expectation of IRS access, but that IRS access is allowed absent a privilege, is circular and begs the judicial question. Last, in situations in which the information is not collected with an eye towards filling out the tax return and in which the accountant's Code of Professional Ethics requires confidentiality, one could fairly conclude that the vast majority of the communications with which the accountants are concerned do originate in a confidence that they will not be disclosed.

Court Today, 31 TUL. L. REV. 101, 109-15 (1956). As support, he quotes the following passage from Wigmore: "'Certainly the position of the . . . adviser would be a difficult and disagreeable one; for it must be repugnant to any honorable man to feel that the confidences which his relation naturally invites are liable at the opponent's behest to be laid open through his own testimony.'" *Id.* at 112 (quoting 8 J. WIGMORE, *supra* note 178, § 2291, at 553). While Louisell's attack calls into question the evaluation of a potentially original privilege by Wigmorean standards, it supports the creation of an accountant-client privilege. Louisell states:

[I]n the long run insistence upon precise analysis of the reason for privileged communications, and close inquiry into the true nature and psychological, social, historical and moral importance to human freedom of claims to privilege, will best separate the genuine from the spurious. Conversely, it is the hodge-podge treatment of all the privileges . . . that conduces toward making all privilege a mere matter of professional jealousy and contention

Id. at 114-15.

193. *Couch v. United States*, 409 U.S. 322, 335 (1973).

194. *Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 12, United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

195. *Id.* at 13. The second Wigmore requirement is intimately related to the fourth requirement. Whether confidentiality is essential to a relationship will largely turn upon whether the benefit gained by the IRS auditing process outweighs the possible reduction of corporate cooperation with the outside accountant.

196. Caplin, *Tax Accrual Workpapers*, *supra* note 40, at 69; *see supra* note 55 and accompanying text.

197. AICPA Rules of Conduct, Rule 301, 2 AICPA, PROFESSIONAL STANDARDS (CCH) § 301.01 (1980).

198. [1 Audit] I.R.M. (CCH) § 4233 (232.8(4)) (rev. May 14, 1981).

The IRS argument that confidentiality is not "essential to the full and satisfactory maintenance" of the accountant-client relationship¹⁹⁹ is troublesome. The Service argues that confidentiality is not necessary because obligations placed upon both the corporation and the accountants by the securities laws compel disclosure. The accounting profession, however, can point to the actual harm that has already resulted from the uncertainty caused by disparate lower court decisions.²⁰⁰ Furthermore, even the Service recognizes the need for confidentiality between the accountant and its corporate client.²⁰¹ It is only for itself that the Service would like to penetrate the barrier of confidentiality. Thus, the first two elements of Wigmore's test²⁰² support an accountant-client privilege.

Wigmore's third requirement is also quite easily satisfied; a number of considerations indicate that the accountant-client privilege is one "which in the opinion of the community ought to be sedulously fostered."²⁰³ The accounting profession has grown at a remarkable rate²⁰⁴ because of an ever increasing demand by lending institutions, investors, and government agencies for financial analysis and assistance.²⁰⁵ One commentator considered the "increasing reliance by the general public on the services of the public accountants"²⁰⁶ sufficient evidence to satisfy Wigmore's third requirement.²⁰⁷ Additionally, fifteen states have considered the issue and determined that a confidential relationship with accountants is desirable, necessary, and entitled to the protection of an accountant-client privilege.²⁰⁸

A more difficult question is whether the community would foster the relationship of accountant and client at the expense of IRS efficiency in the auditing process. The Service questions, and most of the litigation implicitly revolves around, whether Wigmore's fourth requirement is met—whether "[t]he injury that would inure to the relationship by the disclosure of the communications . . . [is] greater than the benefit thereby gained"²⁰⁹ in the administration of justice or the efficient collection of the

199. 8 J. WIGMORE, *supra* note 178, § 2285, at 577.

200. See Hanson & Brown, *CPAs' Workpapers: The IRS Zeros In*, J. ACCT., July 1981, at 68.

201. See *infra* text accompanying notes 212-13.

202. See *supra* text accompanying note 180.

203. 8 J. WIGMORE, *supra* note 178, § 2285, at 577.

204. Katsoris, *Confidential Communications—The Accountants' Dilemma*, 35 FORDHAM L. REV. 51, 52 (1966).

205. See *id.*; see also National Conference of Lawyers and CPAs, *Lawyers and Certified Public Accountants: A Study of Interprofessional Relations*, 36 TAX LAW. 26 (1982). There are approximately 192,000 CPAs in the United States employed in public practice, corporate employment, government, and teaching. "The information which accounting provides is essential for: (1) effective planning, control, and decision making by management, and (2) discharging the accountability of organizations to investors, creditors, government agencies, taxing authorities, association members, contributors to welfare institutions, and others." *Id.* at 28.

206. Note, *Evidence—Privileged Communications—Accountant and Client*, 46 N.C.L. REV. 419, 423 (1968).

207. See *supra* text accompanying note 180.

208. ARIZ. REV. STAT. ANN. § 32-749 (1976); COLO. REV. STAT. § 13-90-107 (1974); FLA. STAT. ANN. § 473.316 (West 1982); GA. CODE § 42-3-32(b) (1977); ILL. ANN. STAT. ch. 110-1/2 § 51 (Smith-Hurd 1966); IND. CODE § 25-2-1-23 (1974); KY. REV. STAT. ANN. § 325.440 (Bobbs-Merrill 1969); LA. REV. STAT. ANN. § 37.85 (West 1974); MD. CTS. & JUD. PROC. CODE ANN. § 9-110 (1974); MICH. COMP. LAWS ANN. § 339.713 (Supp. 1983-1984); MO. REV. STAT. § 326.151 (Supp. 1975); NEV. REV. STAT. § 49.195 (1971); N.M. STAT. ANN. § 38-6-6(c) (1973); PA. STAT. ANN. tit. 63, § 9.11a (Purdon Supp. 1983-1984); TENN. CODE ANN. § 62-1-116 (1982); P.R. LAWS ANN. tit. 20, § 790 (1961). For a general discussion and analysis of the various state-created accountant-client privileges, see Note, *Government Access to Corporate Documents*, *supra* note 2, at 369-73.

209. 8 J. WIGMORE, *supra* note 178, § 2285, at 577; see *supra* text accompanying note 180.

revenues. The accounting profession asserts that the threat of IRS access to an accountant's tax accrual workpapers has had a substantial negative impact on the auditing process.²¹⁰ The profession has "seen a drying up of the willingness of clients to discuss or even show data to their auditor. And the bottom line is that [this is not] leading to good financial reporting[;] . . . auditors aren't receiving information to do proper audits, and that will lead to more qualified opinions."²¹¹ IRS Commissioner Egger noted that IRS attempts to review tax accrual workpapers were "driving a wedge between CPA's and their clients."²¹² Former Commissioner Caplin stated that "[c]andid communication between accountant and client is at stake, as well as protection of the integrity of the financial audit process and the public interest in full disclosure in corporate financial statements."²¹³ These concerns were also at the heart of the Second Circuit's decision in *United States v. Arthur Young & Co.*²¹⁴

The *Arthur Young* court supported the accountants—providing the underlying rationale for their position. Good faith differences can arise between a taxpayer asserting a "minimum tax" position and the IRS acting from a "maximum tax" perspective.²¹⁵ Because the tax code is not cast in black and white and because all parties are merely human, the possibility exists that one position may be preferred over another or that both are to some extent correct.²¹⁶ At the end of an IRS audit the parties are left to negotiate and compromise to reach an appropriate balance, but when compromise is impossible litigation may ensue. Requiring the taxpayer to unilaterally reveal negotiation and settlement positions via the tax accrual workpapers is improper. This is particularly true when the decision not to litigate is based on factors "wholly apart from the inherent legality of what the taxpayer has done," such as "the cost of litigation and the possibility that confidential information may be disclosed to competitors."²¹⁷ This process prejudices the taxpayer by improperly weighting the balance, such that "a prudent organization might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under [section] 7602."²¹⁸ The SEC laws were designed to prevent this kind of informational protectionism. The minimal increase in IRS efficiency is thus outweighed by the investing public's need for complete and accurate information.²¹⁹

210. *Auditors Say IRS Demand for Documents Is Poisoning Relations with Client Firms*, Wall St. J., Jan. 15, 1981, at 25, col. 4.

211. *Id.*

212. IRS News Release, IR 81-49 (remarks by Roscoe L. Egger before the San Francisco Chapter of the California Institute of Certified Public Accountants and Tax Section, San Francisco Bar Association, May 5, 1981).

213. Caplin, *Tax Accrual Workpapers*, *supra* note 40, at 81-82.

214. 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983). The court recognized that [t]he verification procedure envisioned by the [Securities Exchange Act of 1934] requires, in turn, that management feel free to cooperate with their auditors, and to disclose to them confidential information, such as the questionable positions taken on tax returns and willingness to settle rather than litigate when these positions are challenged by the IRS.

Id. at 219-20.

215. *Id.* at 220.

216. *Id.*

217. *Id.*

218. *Id.*

219. *See id.* at 220-21.

The majority opinion in *United States v. El Paso Co.*²²⁰ accurately reflects the conflicting IRS position. For three reasons the *El Paso* court rejected the taxpayer's premise that "the accuracy of financial reports will suffer if companies must divulge their tax pool analysis to the IRS."²²¹ First, the court considered this premise to be wholly speculative.²²² Second, the majority was unwilling to accept the view of American corporations inherent in the taxpayer's argument. The majority cited the *Arthur Young* dissent, which had expressed an unwillingness to assume that corporate clients would violate the law by withholding information from their independent accountant.²²³ Last, the taxpayer's view fails to recognize that the powers of the SEC are sufficient to compel complete disclosure.²²⁴ Both the SEC and professional accounting standards require an accountant to issue a qualified opinion or scope limitation on the corporation's financial statement if material information is withheld.²²⁵ And the corporation faces such severe sanctions from the SEC and the public for an unclean statement that submission to an IRS investigation is probably the path of least resistance.²²⁶

[T]he cost of financial deceit is high for it can cut the corporation off from the public capital markets and expose it to private causes of action. . . . [I]t is the sanctions of the securities laws—not the existence of any privilege—that provide the corporation with the necessary incentive to be candid with its independent auditor.²²⁷

The *El Paso* court refused to constrict the sweep of the IRS summons authority for the additional reason that it was "not swayed by the argument that the public policy of the securities laws implicitly overrides the clear grant of summons power to the IRS."²²⁸ The court, recognizing that Congress gave the Internal Revenue Service a broad mandate of authority to collect and protect the nation's revenue, refused to limit the IRS summoning power "in the absence of a more profound clash between Congressional policies."²²⁹ The IRS has interpreted a relevant Supreme Court decision²³⁰ to require that any conflict in congressional purpose must appear clearly in the statutes themselves.²³¹ Taking the argument one step further, the IRS has argued that since the securities statutes and the revenue collecting laws regulate different activities,²³² no conflict exists between the two.

220. 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

221. *Id.* at 544.

222. *Id.*

223. *Id.* (citing *United States v. Arthur Young & Co.*, 677 F.2d 211, 224 (2d Cir. 1982) (Newman, J., concurring in part and dissenting in part), *cert. granted*, 103 S. Ct. 1180 (1983)).

224. *Id.*

225. See Nath, *supra* note 30, at 1592-93.

226. *Id.* at 1593.

227. Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 14, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

228. 682 F.2d 530, 544 (5th Cir. 1982).

229. *Id.*

230. *St. Regis Paper Co. v. United States*, 368 U.S. 208 (1961) (only a conflict appearing in the statutes themselves will prevent disclosure of census information to the Census Bureau).

231. Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 14, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983).

232. *Id.*

The *El Paso* court decided that the courts are not "free to reweave the fabric of national legislation," because that power belongs to Congress alone.²³³ Particularly, when the Service demonstrates administrative sensitivity and flexibility, it should be permitted to remedy or "temper the perceived ill-effects" of its actions without judicial interference.²³⁴

Wigmore's fourth requirement for privilege extension is thus a veritable cost-benefit analysis, balancing any improvements to the accountant-client relationship against the harm to the proper disposal of litigation.²³⁵ The IRS generally argues that the collection of taxes will be hampered if access to the tax accrual workpapers is denied.²³⁶ The Service wants these documents for convenience in the auditing process and increased convenience means added efficiency and conservation of limited resources.²³⁷

On the accountant's side of the argument is the possible diminution of communications needed to assure compliance with SEC requirements. If the frequency or quality of accountant-client communications is not reduced, the IRS should have access to beneficial documents. The issue is not resolved, however, by the Service's arguments that corporations are required to divulge material information for securities reporting and that accountants have an independent duty to the SEC, the profession, and public investors. The Supreme Court discredited similar arguments in *Upjohn Co. v. United States*,²³⁸ in which it noted,

This response ignores the fact that the depth and quality of any investigations . . . would suffer The response also proves too much since it applies to all communications covered by privilege: an individual trying to comply with the law or faced with a legal problem also has a strong incentive to disclose information to his lawyer, yet the common law has recognized the value of the privilege in further facilitating communications.²³⁹

The Court's analysis is plainly correct. If a corporation perceives that its audit responses may be unfairly used against it at some future date, it is likely to hold its comments and cooperative efforts to the minimum required by law.²⁴⁰ The result is wholly undesirable considering the full disclosure objectives of the securities laws. The Service has recognized that much of the responsibility for the conflict rests on its shoulders and that it has the duty to reduce the tension.²⁴¹ The recent litigation has been a subtle line-drawing process to determine when the Service's authority must

233. 682 F.2d 530, 545 (5th Cir. 1982).

234. *Id.*

235. See *supra* note 180 and accompanying text.

236. See Nath, *supra* note 30, at 1607-10.

237. See *id.*

238. 449 U.S. 383 (1981).

239. *Id.* at 393 n.2.

240. [F]rankness and candor may well lead to vulnerability. This is because . . . every expression of concern, every question raised, every good-faith doubt . . . must be disclosed and will inevitably invite and concentrate IRS scrutiny. Indeed, the company may well be met by a quotation from its own attorney or accountant if it should later challenge an IRS position or attempt a reasonable settlement of a dispute.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit at 18, *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

241. See *supra* note 212 and accompanying text.

take a back seat to the preservation of complete communication between auditor and client.

Wigmore's first three privilege requirements are rather easily satisfied in the accountant-corporate client context.²⁴² Satisfaction of the fourth and final requirement—that the injury to the accountant-client relationship be greater than the benefit gained in the administration of justice—is extremely difficult.²⁴³ The balancing test is ultimately for the courts. The accounting profession has argued, and the present IRS Commissioner has admitted,²⁴⁴ that communications between accountants and their clients have been reduced and the relationship damaged. That impaired communication will have a negative impact on the reliability of certified financial statements is a highly likely, and undesirable, consequence. Permitting the IRS access to a taxpayer's legal theories and settlement positions certainly does not benefit the administration of justice or result in the correct disposal of litigation. Rather, disclosure of the information in tax accrual workpapers unfairly tips the balance against the taxpayer.

The threat to the attorney-client privilege when information is discussed with an outside accountant is also a significant problem to be considered. The Supreme Court has evidenced a desire “to encourage full and frank communication between attorneys and their clients . . . [to] thereby promote broader public interests in the observance of law and administration of justice.”²⁴⁵ Yet, without an accountant-client privilege a corporate taxpayer is caught between Scylla and Charybdis. If the taxpayer's accountant has access to the information needed for SEC certification, the taxpayer loses the attorney-client privilege, which requires confidentiality. If the taxpayer protects his right to the attorney-client privilege by denying access to his accountant, he suffers his fate before the Securities Exchange Commission.²⁴⁶ As the dissenter in *El Paso* noted in the context of a waiver argument, “[i]f we do not take these realities into account . . . there is a substantial danger that the attorney-client privilege for publicly held corporations, so recently reaffirmed in *Upjohn Co. v. United States* . . . will become nothing but an empty theory.”²⁴⁷

The similarity and occasional overlap of function between an accountant and an attorney should also be considered. The National Conference of Lawyers and Certified Public Accountants recognized that “[a]n important part of the CPAs' service to clients includes tax planning, preparation of tax returns and appearances before the Internal Revenue Service,”²⁴⁸ and noted, “Frequently the legal and accounting phases are so interrelated, interdependent and overlapping that they are difficult to

242. For an article indicating that all four of the Wigmore requirements are easily satisfied, see Note, *Protecting the Auditor's Work Product from the IRS*, 1982 DUKE L.J. 604, 622-23.

243. *But see id.*

244. *See supra* note 212 and accompanying text.

245. *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).

246. *See supra* note 28 and accompanying text.

247. 682 F.2d 530, 551 (1982) (Garwood, J., dissenting), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

248. National Conference of Lawyers and CPAs, *Lawyers and Certified Public Accountants: A Study of Interprofessional Relations*, 36 TAX LAW. 26, 29 (1982).

distinguish. This is particularly true in the field of income taxation, where questions of law and accounting are often inextricably intertwined."²⁴⁹ In such a state of affairs a communication made to an attorney may be considered privileged while the same words communicated to an accountant remain unprotected. Rather than remove the privilege from the attorney-client relationship, the appropriate response seems to be some form of protection to the accountant when he is providing tax planning advice.²⁵⁰ Lawyers should not be able to "woo companies away from accountants"²⁵¹ by promising insulation for a company's tax accrual information when no distinction can be drawn on the basis of the type of work done. Courts have responded by requiring that all accountant communications go through an attorney, thereby gaining protection via the attorney-client privilege. But the use of this legal fiction should be replaced by direct protection for the accountant's work.

IRS self-control is an inadequate solution to its conflict with the accounting profession.²⁵² Although the Service, in May 1981, adopted procedural guidelines that require an agent, *inter alia*, to identify specific issues for investigation, request the needed information from the taxpayer, limit the summons to the specifically identified issues, and receive approval for the summons from the Chief of the Examination Division,²⁵³ judicial reliance on the Service to police itself suffers from a number of deficiencies. Because an accountant's tax accrual workpapers are still summonable, a corporate taxpayer may continue to fear disclosure of sensitive matters.²⁵⁴ "[T]he rule changes do nothing to relieve the unfairness of using the company's own auditor against it in a tax investigation."²⁵⁵ Furthermore, the new procedures do not change the fact that the decision remains in the Service's discretion at a time when the Service is most likely to favor itself. IRS procedures are considered informal, nonbinding rules,²⁵⁶ and the Service may interpret them as it chooses.²⁵⁷

This Comment favors the creation of an accountant-client privilege, but recognizes an alternative solution that is equally effective, less restrictive, and within the bounds of existing law.

D. Substantial Countervailing Policy Analysis

In *United States v. Euge*²⁵⁸ the Supreme Court recognized that substantial countervailing policies may justify limiting IRS authority to summon tax accrual

249. *Id.* at 33.

250. Jentz, *Accountant Privileged Communications: Is It a Dying Concept Under the New Federal Rules of Evidence?*, 11 AM. BUS. L.J. 149, 156 (1973).

251. Legal Times, Apr. 19, 1982, at 6, col. 2.

252. *But see* *United States v. El Paso Co.*, 682 F.2d 530, 545 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716). The court noted that the change in procedural guidelines evidenced an administrative flexibility and sensitivity that reinforced the decision not to trim the Service's authority. *Id.*

253. [I Audit] I.R.M. (CCH) § 4024.4 (rev. May 14, 1981).

254. Note, *Protecting the Auditor's Work Product from the IRS*, 1982 DUKE L.J. 604, 615-16.

255. *Id.* at 615.

256. *United States v. Caceres*, 440 U.S. 741 (1979); Note, *Protecting the Auditor's Work Product from the IRS*, 1982 DUKE L.J. 604, 616.

257. Note, *Protecting the Auditor's Work Product from the IRS*, 1982 DUKE L.J. 604, 616.

258. 444 U.S. 707 (1980).

workpapers.²⁵⁹ Policy considerations, even if insufficient to warrant the creation of an accountant-client privilege or a work product immunity, are adequate to require some restriction on IRS action. A court may consider all countervailing interests. Against the Service's concern for the efficient collection of taxes are a number of policies that substantially reduce the efficacy of permitting IRS access to tax accrual workpapers. A court considering this issue should recognize that permitting the accountant to operate free from the fear of forced disclosure of client confidences enhances the function of counselling and the moral state of the accountant as tax counsellor;²⁶⁰ that protecting an accountant's tax accrual workpapers is a step toward recognizing the evolution of accounting as a profession and the functional overlap that has developed between accountants and lawyers;²⁶¹ that eliminating the forced disclosure of potential settlement positions ensures a proper balance between the taxpayer and the IRS in settlement negotiations;²⁶² and that eliminating the fear of disclosure to the IRS promotes complete and accurate securities reporting, which, in turn, encourages "the maintenance of fair and honest markets in [securities] transactions."²⁶³

Substantial countervailing policy analysis permits a court to decide a case like *Arthur Young* on the narrowest possible grounds. The information contained in tax accrual workpapers can be protected from IRS review without the creation of a privilege never before recognized in the federal courts. Furthermore, because substantial countervailing policy analysis applies only to a section 7602 summons, the protection limits IRS access to tax accrual workpapers, but not the access of other litigants.

Substantial countervailing policy analysis allows a court to choose between standards of protection. An across-the-board approach may be warranted by the countervailing policies previously mentioned. A court may decide that in cases dealing with tax accrual workpapers a per se rule prohibiting IRS access would best serve the interests of the public. Alternatively, a court may choose a case-by-case approach that balances all the interests according to the fact situation at hand. Under this test the IRS need not be absolutely precluded from information unobtainable from any other source. A "needs test," similar to that used in Rule 26(b)(3) of the Federal Rules of Civil Procedure might be applied,²⁶⁴ with the burden of proof placed on the Service to rebut the presumption that tax accrual workpapers should be protected.

IV. CONCLUSION

A substantial number of important policy considerations should limit the traditionally broad IRS summons authority when that authority is directed toward an independent accountant's tax accrual workpapers. These policy considerations do not

259. *Id.* at 711.

260. *See supra* note 192.

261. *See supra* text accompanying notes 248-51.

262. *See supra* text accompanying notes 215-19.

263. *United States v. Arthur Young & Co.*, 677 F.2d 211, 219 (2d Cir. 1982), *cert. granted*, 103 S. Ct. 1180 (1983); *see supra* text accompanying notes 238-40.

264. FED. R. CIV. PROC. 26(b)(3).

make the workpapers irrelevant to determining the correctness of a tax return or the amount of a person's tax liability; they do require the creation of some form of protection for tax accrual workpapers, since no statutory prohibition exists. The work product doctrine, enunciated in *Hickman v. Taylor*, is a judicial theory laden with rules for its own application. Although the doctrine provides a potentially workable solution to the problem, tax accrual workpapers are not prepared in anticipation of litigation and, therefore, do not satisfy the requirements of the work product doctrine. An accountant-client privilege, not yet recognized in the federal courts, would do much to achieve a just resolution of the issue. Protection of the accountant-client relationship provides an overall societal benefit that exceeds the Service's need for increased efficiency in the collection of tax revenues and is thus justified by policy considerations. Congress desired to provide American securities investors with complete and accurate information, but did not intend that the information be used to a taxpayer's disadvantage in litigation or in settlement proceedings.

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